Agenda Date: 1/08/03
Agenda Item: 2H

STATE OF NEW JERSEY
Board of Public Utilities
Two Gateway Center
Newark, NJ 07102
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DIVISION OF ENERGY

IN THE MATTER OF PUBLIC SERVICE ELECTRIC AND GAS COMPANY'S APPLICATION FOR AN ACCOUNTING ORDER PERMITTING IT TO RECORD A PORTION OF ITS MINIMUM PENSION LIABILITY AS A REGULATORY ASSET ON ITS BALANCE SHEET	)	Order Denying Proposed Accounting Treatment Docket No. EO02110853

(SERVICE LIST ATTACHED)

BY THE BOARD:

By letter to the Board dated November 13, 2002, Public Service Electric and Gas Company ("PSE&G" or "the Company") applied for an accounting order that would permit it to record a regulatory asset associated with the utility portion of a Minimum Pension Liability ("MPL") it expected to book in fiscal year 2002 in compliance with Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* ("FAS 87"). FAS 87 sets forth the accounting prescribed for pension funds by the Financial Accounting Standards Board ("FASB"), and was adopted by the Company in 1987. Among other provisions, it requires the market value of pension plan assets to be periodically measured and compared to the accumulated pension benefits payable under the plan (the "Accumulated Benefit Obligation" or "ABO"), and if the ABO exceeds the value of the plan assets, the difference (the MPL) must be recorded as a liability on the Company's balance sheet as of the date the measurement is made (the "measurement date"). For PSE&G, this is December 31st, the end of its fiscal year.

The pension plans for which the proposed accounting is requested pre-date the restructuring of PSE&G into an electric and gas distribution company in accordance with the Board's Final Order[1] implementing the restructuring and other provisions of the

[1] *I/M/O Public Service Electric and Gas Company's Rate Unbundling, Stranded Costs and Restructuring Filings,* Docket Nos. EO97070461, 462 and 463, Order dated August 24, 1999.

1999 Electric Discount and Energy Competition Act (_N.J.S.A_. 48:3-49 *et seq*., "EDECA"). Thus the plans cover the active and retired employees of the unregulated subsidiaries of the parent company, Public Service Enterprise Group, Inc. ("PSEG," "Enterprise" or "parent company"), including former utility employees transferred to these subsidiaries as a result of the restructuring, as well as the employees and retirees of the utility. As of December 31, 2001, approximately 11,500 active employees were covered by the plans to which the requested accounting order would apply. Of these, about 58%, are employees of the electric and gas segments of the utility, an additional 2% are employed in the transmission segment (which although part of the utility, is no longer regulated by the Board), and approximately 40% are employed in Enterprise's unregulated businesses, principally PSEG Power, LLC ("PSEG Power"), which prior to the restructuring comprised the utility's electric production segment. The plans, three in number, are qualified plans (collectively "the plan" if used in the singular herein) under the Employee Retirement Income Security Act ("ERISA"). In the year ended September 30, 2002, they provided $153 million in benefits to approximately 7,900 retirees.[2]

As a result of declines in the stock market in 2001 and 2002, the market value of plan assets will be less than the ABO at year-end 2002 for the first time in the plan's history. In the petition as filed, the market value of plan assets was projected to be $2.003 billion at year-end, as compared to an ABO of $2.451 billion on that date, yielding a projected MPL of $448 million, based on the market value of the trust funds as of September 30, 2002. Subsequent improvement in the stock market in October, and to a lesser extent in November, reduced the projected MPL to $342 million based on October data, and then to $285 million based on November data.[3]

Of the total currently-projected MPL of $285 million, 56.8%, or $162 million has been allocated to the regulated utility by the Company, based on an actuarial determination of the percentage of the ABO attributed to the service of active electric and gas employees, and the additional assumption that this same percentage should be applied to the portion of the ABO attributable to retirees. Based on information provided by the Company, if the proposed accounting were approved by the Board, this amount (the $162 million) would equate to a regulatory asset recorded on the asset side of the utility's balance sheet of $287 million, after adding and subtracting other components of

[2] Regulatory asset treatment of the MPLs associated with two other non-qualified plans applicable to Company employees hired after 1996 is not being sought because those plans are not subject to the funding and legal requirements of ERISA. As of December 31, 2001, 248 active and 212 retired employees were covered by these plans. The differences between the qualified and non-qualified plans are set forth in more detail in the Company's response to S-PF87-23. How many employees and retirees are covered by each plan is set forth in the responses to S-PF87-48.

[3] The November update also reflected a change in the discount rate assumption from 6.50% to 6.75%. The final MPL and associated regulatory asset as of the December 31, 2002 measurement date are preliminarily expected to be $280 million and $284 million, respectively, assuming the Company's outside auditors approve the change in the discount rate assumption, as indicated by the Company's response to S-PF87-14 (suppl. 2).

pension cost prescribed by FAS 87.[4] If the proposed accounting were not approved, the $287 million, net of tax, or $170 million, would be written off to accumulated Other Comprehensive Income ("OCI"), a component of the utility's common equity. When added to the $131 million equity write-off associated with the unregulated businesses (including the utility's transmission segment), which must be taken regardless of the outcome of the Company's petition, the total equity write-off for Enterprise consolidated would be $301 million.

In order for the Company to record the regulatory asset, it must meet criteria set forth in another accounting statement issued by the FASB, Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* ("FAS 71"), which requires that the recovery of the asset through future rates must be probable, i.e., "can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved."[5] As represented by the Company and its outside auditors, Deloitte & Touche, LLC ("Deloitte & Touche" or "D&T"), the requested regulatory asset treatment would meet this requirement as long as the Board issues an accounting or rate order supporting the probability of continued inclusion of pension costs in future rates.

In its petition seeking the issuance of the accounting order, the Company asserts that the requested accounting treatment would not have any effect on the amount or timing of any present or future pension expense,[6] and that changes in the MPL will be effectuated solely through balance sheet accounting on subsequent measurement dates to reflect the effects of future pension trust performance and funding, as well as other factors, such as changes in work force demographics, changes in the plan's provisions, and the discount rate employed in reducing the future benefits payable under the plan to present value. The effect of these same factors would also be recognized in the income statement over time through the normal course of pension accounting under FAS 87. The Company asserts that through a combination of improved investment returns and ongoing funding, it expects the MPL and associated regulatory asset to be reduced going forward.[7]

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[4] Adding "Prepaid Benefit Cost" and subtracting an "Intangible Asset" representing the unamortized balance of prior service and transition obligation costs, as shown on page 4 of Attachment A to this Order.

[5] FAS 71, paragraph 9, footnote 6.

[6] The increase in pension expense resulting from the factors that gave rise to the MPL has, however, been reflected in the Company's electric distribution base rate case (*I/M/O the Petition of Public Service Electric and Gas Company for Approval of Changes in the Tariff for Electric Service, B.P.U.N.J. No. 14 Electric Pursuant to N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1, for Changes in its Electric Depreciation Rates Pursuant to N.J.S.A. 48:2-18, and for other Relief*, Docket No.ER02050303) as indicated by the updated claim of $21.9 million included in the Company's "9+3" test year update filed on December 3, 2002, as compared to the $17.8 million claimed for pension expense in the initial filing on May 24, 2002.

[7] If the proposed accounting were denied, these same factors would yield credits to OCI, thereby restoring the equity reduction that must be taken in lieu of establishing the regulatory asset.

In support of its petition, the Company states that the necessity for recording the MPL is due to a widespread and prolonged decline in stock prices, as evidenced by investment losses of 3.1% and 12.6% suffered by its pension trust funds in the year 2001 and the nine months ended September 30, 2002, respectively. Even so, the Company asserts that the performance of its trust funds has been better than that of many other large corporate and utility pension funds during these same periods.

As the Board's authority for issuing the requested accounting order, the Company cites *N.J.S.A.* 48:2-16 (2) (a) and *N.J.A.C.* 4:6-5.1, and requests that the Board consider the petition on an expedited basis so that the appropriate accounting entries could be recorded on the Company's books for the fiscal year 2002.

PROCEDURAL HISTORY

After filing its petition the Company met with the Board's Staff on November 14, 2002, and with the Division of the Ratepayer Advocate ("Ratepayer Advocate," "RPA" or "Advocate") on the following day to review the pension accounting prescribed by FAS 87 and the effects the Company's accounting proposal would have if it were approved by the Board. Several of the schedules prepared by the Company and reviewed at these meetings were subsequently updated to reflect the market value of the plan assets as of November 30, 2002, and have been appended hereto as Attachment A. Over 100 data requests were issued by the Board's Staff and the RPA and responded to by the Company over the next several weeks. Among other issues, these data requests explored the potential rate impacts the proposed accounting would have if it were approved by the Board, whether the proposed regulatory asset would in fact qualify for that treatment under FAS 71, as compared to regulatory assets previously approved by the Board, and whether any other utilities, either in-state or nationwide, have sought such treatment for their MPLs.

On November 22, 2002, D&T issued a letter (the "D&T letter") which opined that "the Company's conclusion that recording a Regulatory Asset for costs related to the portion of the Minimum Pension Liability that would otherwise be charged to OCI for its rate regulated operations under the jurisdiction of the BPU, is an appropriate application of SFAS No. 71, as long as the Company is able to obtain a rate or accounting order from [the Board]." The D&T letter, as well as the Company's responses to the initial round of data requests was reviewed at a meeting attended by the Company, the Board's Staff and the Ratepayer Advocate on that same date. An additional meeting was held on December 3, 2002 to again review responses to data requests and answer additional questions from Staff and the RPA. On December 5, 2002, initial comments on the Company's accounting proposal were filed by the Company and the RPA. On December 10, 2002, the Company replied to the RPA's comments, and on December 17, 2002, the Advocate responded to the Company's reply. Additionally, by letter to the Board's Chief Economist and Executive Director dated December 13, 2002 (the

“December 13th letter”), with copies to the Service List, Thomas M. O’Flynn, Executive Vice President and Chief Financial Officer of the parent company, summarized from his perspective the key issues raised during discovery, and how they might be addressed in order to facilitate a timely decision by the Board, now targeted for January 8, 2003, the date of the Board’s first regularly-scheduled public meeting in 2003.

PSE&G’s INITIAL COMMENTS

In urging the Board to approve the requested accounting treatment, the Company asserts that it is consistent with Generally Accepted Accounting Principles (“GAAP”), as embodied in FAS 71 and FAS 87 and concurred with by Deloitte & Touche, that it would have no incremental rate impact, and that it would be adjusted annually (on December 31st) via the measurement test required to be performed by FAS 87 as well as indirectly through the income statement, again in accordance with the accounting prescribed by FAS 87, making amortization of the regulatory asset in the traditional sense unnecessary. PSE&G further asserts that approval of the requested treatment would not preclude rate case review of the Company’s pension expense, including the reasonableness of the allocation of the MPL and related regulatory asset to the regulated utility. Denying the requested treatment on the other hand would, the Company maintains, reduce the already lean equity component of its capital structure, assertedly the least expensive of any of the state’s major utilities, and potentially could have a detrimental effect on the Company’s access to and cost of capital.

In further support of its petition, the Company states that its pension trust funds have performed as least as well as those of similar pension funds during the last two years of the declining stock market, and avers that Board approval of the requested accounting treatment would not set a precedent for the state’s other utilities due to the fact-specific nature of the Company’s petition. Finally, the Company reasserted the need for a Board decision on the petition before the end of the fiscal year.

RATEPAYER ADVOCATE’S INITIAL COMMENTS

In recommending that the Board reject the Company’s proposed accounting treatment as not being in the best interest of ratepayers, the Advocate expressed a number of legal, ratemaking policy and practical concerns, as follows:

Legal Concerns

Citing the Board’s approval of regulatory asset treatment for costs incurred by Rockland Electric Company (“RECO”) in extending the life of its deteriorating underground cables as an example,[8] the RPA argues that the Board has historically granted requests to

[8] In Docket No.EO95010009, *I/M/O Rockland Electric Company for Deferral of Underground Electric Cable Injection Costs – Cablecure*, Order dated January 12, 1996 (the “Cablecure proceeding”).

create regulatory assets very sparingly, and in only a few specific, extraordinary circumstances, none of which the RPA finds present in the instant case. Unlike RECO's Cablecure proceeding, in which the Board allowed incurred costs to be capitalized pending their review in RECO's next base rate case, the RPA maintains that the pension fund losses at issue here, in that they have resulted from the operation of extraneous economic forces, are not directly tied to the provision of utility service, and similarly, because they have occurred as a result of the economic cycle, are not extraordinary in nature and may reverse over time.

The RPA also asserts that the proposed accounting treatment is distinguishable from the deferred accounting the Board approved for costs associated with the Company's Hope Creek nuclear plant pending resolution of the issue as to when the plant began commercial operation,[9] nor can the proposed treatment be justified on the basis of cost savings and administrative simplicity and efficiency, the reasons the RPA cites for the Board's approval of deferred accounting for purchased sewer treatment costs incurred by a small wastewater utility.[10]

Citing as another distinguishable example the Board's allowance of a regulatory asset in recognizing the liability to pay future income taxes incurred as a result of Princeton Meadows Utility Company having employed flow through of depreciation-related tax benefits in prior years,[11] the RPA asserts that unlike that regulatory asset, the amount at issue here is neither quantifiable nor ultimately reversible in the same way tax timing differences are. The RPA additionally distinguishes the instant request from the Board's allowance of regulatory assets associated with the adoption of FAS 106, *Employers' Accounting for Post-Retirement Benefits other than Pensions* ("PBOPs"), which required the state's utilities to switch from a cash basis of accounting for these benefits to an accrual basis. Again using RECO as an example, the RPA cites the establishment and amortization of a regulatory asset to eliminate that company's FAS 106-related transition obligation over a 15-year period.[12] As a final category of distinguishable regulatory assets the RPA cites those associated with utility plant abandonments, which, unlike the pension assets at issue here, the Advocate maintains, were extraordinary in nature and directly tied to the provision of utility service.

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[9] *I/M/O the Petition of Public Service Electric and Gas Company for an Increase in Rates and I/M/O the Petition of Public Service Electric and Gas Company for an Increase in Rates – Hope Creek Proceeding*, Docket No. ER85121163, Order dated January 12, 1987.

[10] *I/M/O Maxim Sewerage Corporation for Approval to Implement Deferred Accounting,* Docket No. WO95120660, Order dated June 4, 1996.

[11] *I/M/O Princeton Meadows Utility Company – Approval to Increase Rates for Sewer Service and a Change in Depreciation Rates,* Docket No. WR92040394J, Order dated January 10, 1994.

[12] *I/M/O Rockland Electric Company for Recognition of a Regulatory Asset Relating to PBOP Costs,* Docket No. ER97080567, Order dated December 17, 1997

Ratemaking Concerns

The RPA contests the Company's assertion that its proposed booking of the regulatory asset will not have any ratemaking implications, maintaining instead that based on the Company's projection of an MPL (i.e., a regulatory asset) of $381 million based on the market value of the plan's assets as of the end of September 2002, the utility's common equity balance would be reduced by $225 million, or from 41.4% of total capital to 38.9%, and its revenue requirement for return (including income taxes payable on the equity component) by $9.5 million[13] if the proposed accounting treatment were denied and the effect of the resultant equity write-off on the Company's capital structure reflected in its currently-pending electric base rate case. This assumes no other change, i.e., that the revenue reduction that would result from the lower equity ratio would not be largely, if not completely offset by an increase in the required rate of return on equity ("ROE") to reflect the increased financial risk the lower equity ratio would entail, as argued by the Company.

Even after taking a possible increase in the ROE into account, the RPA asserts that the reduction in the revenue requirement would still be $7.6 million when the testimony of its witness in the Company's recently-concluded gas base rate case, on which the Company relied in making its increased equity risk argument, is properly interpreted and applied.[14] In determining his recommended ROE in the gas case, RPA witness James Rothschild added 35 basis points (0.35 percentage points) to the ROE he determined for a barometer group of gas companies to allow for the fact that the equity component of the Company's capital structure, at 38.21%, was 9.06 percentage points lower than the 47.27% average equity ratio of the barometer group. Since the difference in equity ratios at issue here is only 2.5 percentage points (38.9% vs. 41.4%), or only approximately 27% of the 9.06 percentage point difference in equity ratios considered in the gas rate case, the Advocate maintains that the risk increment here should only be 27% of the 35 basis points, or approximately 10 basis points. If reflected in the revenue requirement for return in the Company's pending electric distribution case, this would offset the $9.5 million reduction that would result from the lower equity ratio alone by $1.9 million, yielding a net reduction of $7.6 million.

The RPA's ratemaking concerns extend to the presumption of recoverability required by FAS 71, which the RPA asserts could make it more difficult for the parties in future

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[13] Excluding the 6% New Jersey Sales and Use Tax ("SUT"). With the SUT included the rate impact (reduction in billings to customers) would be $10.1 million. Similarly, the $7.6 million net rate impact calculated by the RPA would be $8.1 million with the SUT included.

[14] *I/M/O the Petition of Public Service Electric and Gas Company for Authority to Revise its Gas Property Depreciation Rates* and *I/MO the Petition of Public Service Electric and Gas Company for Approval of an Increase in Gas Rates and for Changes in the Tariff for Gas Service B.P.U.N.J. No. 12, Gas Pursuant to N.J.S.A. 48:2-21 and N.J.S.A 48:2-21.1*, Docket Nos. GR01050297 and GR01050328, Order dated January 9, 2002. Exhibit RA-7, Direct Testimony of Ratepayer Advocate witness James Rothschild.

PSE&G rate cases to take issue with the pension costs implicit in the regulatory asset balance. Moreover, this balance could potentially grow to a much larger amount if the recent poor performance of the stock market continues, and the balance isn't eliminated through the normal operation of the FAS 87 accounting. That in turn could lead to a claim for amortization through rates in a future rate proceeding, as has been the treatment accorded all previous and existing regulatory assets approved by the Board for the Company.

That the proposed accounting has not been requested by any of the state's (or possibly the nation's) other utilities is another RPA concern. To date, the parent companies of only two other New Jersey utilities have booked, or indicated they expect to book MPLs: New Jersey Resources, Inc., the parent company of New Jersey Natural Gas Company, which wrote off $8.6 million to OCI, i.e., to stockholders' equity in its fiscal year ended September 30, 2002, and FirstEnergy, Corp., the parent company of Jersey Central Power & Light Company ("JCP&L"), which, in a news release issued on December 3, 2002, indicated it expects to take an equity write off associated with its MPL at the end of 2002.[15] The RPA is also concerned that PSE&G, while asserting that it has verbal assurances from both the staff of the FASB and D&T concurring with its proposed regulatory asset treatment, has nothing in writing from either.[16]

Moreover, with respect to the Company's assertion that three other utilities outside New Jersey have existing FAS-87-related regulatory assets, the RPA asserts that the Company failed to provide any evidence as to whether the regulatory assets booked by those utilities were the same as the MPL-related asset at issue here.

As yet another ratemaking concern, and while recognizing that PSE&G's last combined electric and gas rate case was stipulated and consequently that no determination of allowable pension expense was explicitly made in that case, the RPA maintains that the parent company's pension expenses booked in the 10-year period beginning in 1993, when the rates approved in the last combined case became effective, through 2002, indicate that the utility's ratepayers have been paying rates based on the higher expense booked in 1993 ($70.1 million) as compared to the much lower expenses booked in the 1998-2001 period, and the $59 million average annual expense booked over the entire 10-year period.[17] Moreover, PSE&G did not propose to return to ratepayers any overcollection of pension expense that occurred during this period, and thus it is unfair to now, in the RPA's words, "burden ratepayers with the establishment of the proposed Regulatory Asset at a time when it is anticipated that the Company's pension expenses will experience significant increases."

[15] FirstEnergy subsequently wrote off $448 million, as indicated in a letter to the investment community dated January 21, 2003.

[16] As indicated above, D&T did, however, issue a letter concurring with the Company's proposed treatment on November 22, 2002.

[17] The annual amounts are shown in the first column on page 1 of Attachment A.

As a final policy concern, the RPA maintains that allowing PSE&G to avoid taking an equity write-down to recognize underfunding of its pension plan would remove an incentive for it to operate its plan as efficiently as possible, and could lead the Company to limit its funding of the pension trust fund to the minimum required by ERISA during periods when cash is scarce, knowing that any resultant underfunding could simply be booked to the regulatory asset account rather than taken as a write-down to equity.

Practical Concerns

The Advocate raises the possibility of creating potentially confusing, or even potentially misleading information that might be passed on to investors if PSE&G were to be the only utility in New Jersey or perhaps the United States that was allowed to use regulatory asset accounting rather than an equity write-down to recognize underfunding of its pension plan. Finally, the regulatory asset might reverse itself over time, as evidenced by the $106 million reduction that occurred as a result of the improved performance of the stock market in just the single month of October 2002, thereby rendering the Company's proposal moot.

Conclusion, RPA's Initial Comments

In concluding its comments, the RPA again recommended that the Board reject PSE&G's accounting proposal for the following reasons:

1. The regulatory asset proposed by PSE&G differs in nature from the underlying costs giving rise to the establishment of a regulatory asset in prior instances where the Board allowed the recording of a regulatory asset;

2. The proposed regulatory asset would increase costs for ratepayers when compared to an equity write-down;

3. The establishment of a regulatory asset pursuant to FAS 71 may give rise to a presumption that the underlying costs and losses are recoverable from ratepayers and preclude a prudence review of these costs in the future;

4. The establishment of a regulatory asset for PSE&G, while other regulated utilities book an equity write-down for their MPL, lead to inconsistencies which may make utility-to-utility comparisons difficult;

5. The establishment of a regulatory asset for the MPL losses is fundamentally unfair since there is no corresponding mechanism to flow the benefits of pension over-funding to ratepayers;

6. PSE&G's proposal would remove the incentive to operate its pension plan as

efficiently as possible;

7. The unique treatment proposed by PSE&G for its MPL has the potential to be misleading to investors; and

8. Finally, the MPL underlying PSE&G's proposed regulatory asset might reverse itself over time, rendering PSE&G's application moot.

THE COMPANY'S REPLY

In its reply comments dated December 10, 2002, the Company urges the Board to reject the Advocate's position opposing the Company's proposal, maintaining that it is factually inaccurate and conceptually flawed. Moreover, the equity write-down it would entail would assertedly increase the cost of the Company's equity and debt, and by virtue of the resultant higher leverage, limit access to the capital markets.

Asserted Factual Errors and Conceptual Flaws

The Company asserts that the RPA erred in stating that the portion of the initially-projected MPL of $448 million (the projection based on September data) that applies to the parent company's unregulated operations is $67 million, when the correct amount is $194 million. Similarly, the RPA also assertedly erred in stating that the booking of the total MPL would result in an equity write-down of $264 million when the correct amount, in the absence of regulatory asset treatment, is $347.7 million.

The Company additionally takes issue with the RPA's characterization of the Company's assumed 9% future return on plan assets as being "unrealistic," asserting that the fund's average annual return over its 34-year existence has, at 9.6%, been higher than that. The Company also states that its pension plan is not now, nor has it ever been underfunded, as that term is defined by ERISA. As to the RPA's assertion that unlike the deferred taxes at issue in the Princeton Meadows proceeding the MPL is not likely to reverse, the Company refers to its November 14th presentation, as well as discovery responses that provide matrices of estimated measurement dates on which the MPL would be extinguished based on various assumed achieved rates of return on plan assets and discount rates.[18]

The Company goes on to assert that it has not been overcollecting its pension expense in rates, as alleged by the RPA, in that the level of annual pension expense supported in the 1991 combined electric and gas rate case was $58.8 million,[19] or about the same

[18] November 14th presentation, pg. 17; response to S-PF87-14, pg. 17; response to S-PF87-15, pg.2; and response to S-PF87-16, pg. 2. Page 17 of the response to S-PF87-14 has been included as page 5 of Attachment A.

[19] Note that this includes the portion applicable to the production segment, which has since been transferred to PSEG Power. In its response to S-PF87-56, the Company clarified the discussion of pension expense appearing on page 5

as the 10-year average of $59 million cited by the Advocate. In addition, the pension expense reflected in the gas base rate case concluded last January was based on the average of the two lowest years, 2000 and 2001, of the 10-year period considered by the Advocate. In reality then, the Company asserts, it is undercollecting its pension costs. On the other hand, the Company avers that its funding of the pension trusts has always been and continues to be within the range of funding called for by ERISA, as evidenced by the $228.4 million it contributed to the pension trust funds in 2002.

<u>PSE&G's Argument</u>

While acknowledging that its requested accounting treatment differs from the traditional utility request for approval to defer previously incurred costs and put them on the balance sheet pursuant to FAS 71, the Company argues that this does not make its proposal unreasonable or wrong. Provided the Board issues an order approving the proposed accounting, D&T and the FASB have concurred that it would be consistent with GAAP, and their concurrence would not in any way be undermined by the Board's having approved the recording of regulatory assets in factually distinguishable cases. With respect to the RPA's assertion that a regulatory asset must be quantifiable to qualify for that treatment, the Company points out that the Board approved deferred accounting for coal tar clean-up costs (i.e., manufactured gas plant remediation ("RAC") costs)[20] which were not quantified at the time of the Board's approval, but in later proceedings in accordance with a procedure still in place today. The Company also takes issue with the RPA's assertion that its request does not involve an extraordinary or unusual cost, in view of the fact that this is the first time in the pension plan's history that the benefits earned by the plan's participants have exceeded the value of the pension trust assets, a situation the RPA itself has described as having arisen from the "operation of extraneous economic forces." Nor can the costs at issue be characterized as not being tied to the provision of utility service, in that they are part of the compensation of the Company's employees who directly provide such service.

With respect to the rate impact of the proposed accounting, the Company continues to maintain that its required ROE would have to be increased by the full 35 basis points adder employed by the RPA's witness Rothschild in the gas rate case to reflect the increased financial risk associated with the lower equity ratio that would result if the proposed accounting were denied. Once that adjustment were made, there assertedly would be no further significant customer savings in revenue requirements from an OCI

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of it reply comments by indicating that in the 1991 rate case it had proposed recovery of $34.5 million and $10.8 million for electric and gas pension expenses, respectively, and at the time of the stipulation in the recent gas base rate case it had requested $10.9 million for pension expense applicable to gas operations.

[20] *I/M/O the Request of Public Service Electric and Gas Company for Deferred Accounting Treatment of Coal Tar Clean-up Costs*, Docket No. GO89070658, Order dated August 8, 1989.

write-off,[21] which in fact could lead to additional costs because of its potential impact on the Company's bond rating, market access and cost of long-term debt.

As to the Advocate's concern that granting the Company's proposed regulatory asset treatment could preclude review of the costs underlying the asset in future rate proceedings, the Company states that that would not be the case, as evidenced by ongoing regulatory reviews of the reasonableness and prudence of the Company's RAC costs as well as the costs recovered by its former Levelized Gas Adjustment Clause (now its BGSS Commodity Charge).

In arguing that approval of the requested accounting treatment would not set a precedent to be followed by the state's other utilities, the Company asserts that any such request for similar treatment on their part would have to be predicated on the facts and circumstances unique to each utility, such as the measurement date for calculating the MPL, the benefits offered by the utility's pension plan and the performance of its trust fund, as well as the size of its MPL relative to that of its common equity.

In refuting the RPA's claim that approval of the proposed accounting might remove an incentive for efficiently managing its pension plans, the Company points to measures in place to ensure effective operation of the plans, including an annual review and audit by D&T, certification of the value of the plan's assets and assumptions by the plan's actuary, and the approval of annual plan funding by the Board of Directors of the parent company. In response to the Advocate's concern as to the possibility of investors being misled should the Company's accounting proposal be approved, as well as the possibility that continuing improvement in the stock market might render the proposal moot, the Company asserts that disclosure via footnotes of pension plan accounting is among the most extensive of any required by GAAP, and that the Company intends to continue to provide such full disclosure in its 2002 10-K. Finally, the Company observes that no regulatory asset would be recorded if the stock market were to go up enough by the end of the year to eliminate the MPL, a possibility it regards as being extremely unlikely.

THE RPA'S RESPONSE TO THE COMPANY'S REPLY

While agreeing that the computational errors cited by the Company were in fact made, the RPA observes that not only do the errors not detract from the relevant points it makes in its initial comments, but they also serve to highlight the complexity of pension accounting, as evidenced by an error of its own the Company makes in incorrectly stating that the total (regulated and unregulated) OCI impact of the initially-projected MPL of $448 million would be $347.7 million without regulatory asset treatment, when

[21] Based on the October update of the projected MPL and an assumed ROE of 12.10% (the 11.75% ROE initially recommended by Company witness Morin plus the 35 basis points increased risk adder), the Company estimated the rate reduction would be $1.0 million without the SUT, or $1.1million with the SUT included (response to S-PF87-20 (suppl.)).

the correct figure is $397.7 million. In any event, the September projection on which that impact is based has been updated to reflect the market value of the plan assets as of October 31, 2002, yielding a more current estimate of the MPL of $342 million, a regulatory asset of $319 million associated with that MPL, and an OCI write off of $188.2 million if FAS 71 treatment of the proposed regulatory asset were denied by the Board.[22]

With respect to the Company's assertion that the RPA incorrectly states that the Company's pension fund is underfunded, as that term is defined by ERISA, the RPA asserts that it intended only to indicate that that is the case in the normal, layman's sense of the term, in that the plan's assets are currently projected to be insufficient to meet its obligations (the ABO). Similarly, the Advocate asserts that its discussion of the pension expense included in rates was intended only to point out that during the period of the 1990's, when pension expense was declining, the Company did not seek to share any of these savings with ratepayers, but now seeks future recovery of its MPL from ratepayers through regulatory asset treatment.

As to the Company's assertion that the MPL will also reverse like the deferred taxes for which regulatory asset treatment was granted in the Princeton Meadows proceeding, the RPA distinguishes the self-correcting nature of the tax reversal from that of the MPL, which the RPA maintains will occur only if market returns are sufficiently positive or if the pension expense charged to the income statement is large enough, or both.

While not arguing that because it is new the Company's proposal is automatically wrong, the Advocate reiterates its concern that the proposal is the first of its kind in New Jersey and perhaps the United States,[23] in contrast to the MPL-related OCI write-offs already taken or expected to be taken by New Jersey Resources, Inc. and FirstEnergy, Corp., respectively.

Finally, with respect to the reduction in the Company's revenue requirement that would result if the Company's accounting proposal were denied and the resultant OCI write-off reflected in the Company's pending electric rate case, the RPA reiterates its assertion that, by maintaining that its required ROE should be increased by 35 basis points, the Company has misinterpreted and misapplied the methodology employed by the Advocate's witness in the gas base rate case. That adder reflected the fact that the

[22] The total OCI impact, regulated and unregulated, would be $335 million. The comparable figures based on the November update are an MPL of $285 million, a regulatory asset of $287 million, and a total OCI write off of $301 million ($131 million unregulated, and $170 million regulated).

[23] On December 20, 2002, the Massachusetts Department of Telecommunications & Energy approved regulatory asset treatment for NSTAR's current and future MPL liabilities, as well as the difference between pension and PBOP expenses booked in accordance with FAS 87 and FAS 106 and the amount included in rates, as indicated in the Company's supplementary response to S-PF87-21. NSTAR is the parent company of regulated operating utilities Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and NSTAR Gas Company.

average equity ratio of the barometer group of companies employed in the gas case was 9 percentage points higher than the Company's, as compared to a difference of only 2.2 percentage points here. Moreover, the RPA asserts that such a small difference is unlikely to have any effect on the Company's bond rating.

The Advocate concludes by reasserting its recommendation that the Board reject the Company's proposal in view of the significant legal, regulatory and practical concerns expressed in both the Advocate's initial comments and in its response to PSE&G's reply comments.

STAFF'S CONCERNS

While Staff did not file formal comments on the Company's accounting proposal, it shared many of the RPA's concerns and raised additional concerns it explored through extensive discovery and in numerous discussions and conferences with the parties.

A threshold issue raised by Staff was the need for more time to insure adequate regulatory review of an issue of first impression as complex and significant in amount as this, an amount that, given the uncertainties surrounding the current stock market, interest rates and the international situation, has the potential to grow even larger going forward.[24] To permit such a review Staff accordingly suggested several interim measures eventually determined to be unacceptable by the Company, and it was ultimately agreed that this matter would be brought to the Board's January 8, 2003 public agenda meeting for the Board's consideration.

Other issues raised by Staff were the applicability of FAS 71; the impact of the OCI write-off on the Company's equity ratio and rates; whether the other parties to the pending base rate case should be given the opportunity to be heard on the Company's proposal; and the potential impact of a denial of the Company's request on the utility's creditworthiness, as well as on the parent company's creditworthiness.

In informal communications to the parties during the course of discovery Staff also suggested a number of ways that some of its and the RPA's concerns could be mitigated, namely by:

1. Eliminating the "open-endedness" of the regulatory asset by i) limiting the requested FAS 71 treatment to only the asset arising as of the December 31, 2002 measurement date (not allowing it to be added to on subsequent

[24] If, for example, the stock market were to decline by 10% during the months of November and December 2002 and by an additional 10% in 2003, as compared to its October 2002 level, the Company estimated that the regulatory asset would grow to $620 million by December 31, 2003 (response to S-PF87-16). On the other hand, if the market were to go up by 10% in November and December 2002 and an additional 10% in 2003, and if the discount rate were increased to 7% from 6.5% currently, the regulatory asset would be eliminated by the end of 2003 (*ibid*.).

measurment dates); and ii) stating that the Board's authorization to record the regulatory asset will expire once the asset has been extinguished.

2. Adding language to the order stating that the regulatory asset could only be extinguished through the balance sheet and other accounting required by FAS 87 (since FAS 71 treatment of the regulatory asset could ultimately lead to a request for amortization of the asset through rates, over and above the pension expense already included in rates).

3. Conducting a generic proceeding to address the accounting issues associated with PSE&G's petition, since the Board's decision on these issues could set a precedent for the state's other utilities whose rates are regulated by the Board.

4. Transferring the record of this proceeding into the pending rate case, where the rate impact issue as well as the prudency and appropriate level of the regulatory asset could undergo additional review.

On a more detailed level, even if the Board were to allow the requested FAS 71 treatment, Staff identified issues as to how much of the proposed regulatory asset should be allowed. Although FAS 87 does not permit "regulatory credits" to be recorded on the balance sheet to reflect the excess of the value of plan assets over the ABO, in both Staff's and the Advocate's view there has clearly been a past equity benefit from the stock market in the years prior to 2000 via reductions in the Company's pension expense (the expense component of "net periodic cost"), and even if this equity benefit were removed from the utility and used for some other purpose, that would not negate that fact.[25] Accordingly, Staff agreed with the Advocate that simple fairness would dictate that this benefit be taken into account in considering the appropriate level of the regulatory asset that should be booked if the Board were to approve the Company's proposal. Other issues identified by Staff that typically would be examined in a rate case included the allocation of the MPL between the parent company's regulated and non-regulated operations, the adequacy of the trust funding, the trust fund's performance relative to its peers, and the reasonableness of the plan's benefits and administrative costs.

THE DECEMBER 13th LETTER

By letter to the Board's Chief Economist and Executive Director dated December 13, 2002, Thomas M. O' Flynn, Executive Vice President and Chief Financial Officer of the parent company, attempted to clarify the Company's request and address some of the concerns raised by Staff and the RPA.

[25] For example, and for illustrative purposes, Staff calculated that the benefit to the Enterprise system from this source could have been as much as $100 million pre-tax over the 4-year period from 1998 through 2001(Staff Data Request S-PF87-24, submitted as a follow-up to S-PF87-17).

The letter states that in order for the Company to avoid an MPL-related reduction in the utility's equity, the Board's Order the Company is requesting must include a statement allowing the Company to debit a regulatory asset account as opposed to OCI, as well as a statement indicating that the Board has in the past and intends in the future to allow the collection of pension expense, calculated in accordance with FAS 87, in rates.

The letter goes on to assert that the proposed accounting "will not result in increased costs to ratepayers nor will the regulatory asset require specific income statement recognition and therefore, its amortization is unnecessary." Moreover, the Company's pension expense would be subject to "all of the traditional justifications and prudency evaluations made in rate cases," including the base case currently underway, and in the event such a review found that elements of the expense were inappropriate and should be disallowed, "the previously established Regulatory Asset would be reduced to reflect this disallowance."

Addressing the Staff's and the Advocate's concerns as to the lack of certainty surrounding the amortization of the regulatory asset, which unlike traditional regulatory assets would not be directly amortized to expense in fixed amounts over a specific time frame, the letter states that the Board "could indicate that the Regulatory Asset approval would expire when the Minimum Pension Liability went to zero. It could also put a dollar limitation on the Regulatory Asset." Such a modification would only place measurable limits on the recovery and not diminish the "probable" standard required under FAS 71.

Absent Board approval of the requested accounting treatment, the resultant reduction in the utility's equity, the letter avers, could lead the rating agencies to lower PSE&G's credit rating, which in turn could affect its ability to "retain strong access to the capital markets…[g]iven the increased bond spreads, reduced credit ratings and difficult access to capital markets experienced by many companies in [the] industry." To illustrate the possibility of a downgrade, the letter points out that Standard & Poor's ("S&P's") benchmarks for maintaining an "A" bond rating include funds from operations ("FFO") coverage of 3.1 times to 3.9 times, and a range of debt as a percentage of total capital of 46.5% to 53%. With its preferred stock counted as equity, the Company's current debt ratio, as calculated by S&P, is 54.4%, and a $200 million reduction in the Company's equity would increase the debt ratio to 56.4%. Although S&P will allow a company to carry more debt if its coverage ratios are stronger, the utility's FFO coverage, at 3.5 times, is about at the middle of the benchmark range for an A-rated company having a lower debt ratio, thus raising the possibility that S&P could re-visit the Company's current credit ratings[26] in the event a reduction in its equity were to occur at the end of 2002.

The letter urges the Board to act on the Company's petition by no later than January 28, 2003, the date on which it must file an 8-K with the Securities and Exchange

[26] The Company's bonds are currently rated A- by S&P, A3 by Moody's, and A by Fitch (response to S-PF87-61).

Commission reporting its 2002 earnings. As a practical matter, the Board's decision would be needed by mid-January, and a written order a week or so later, to allow sufficient time to update the PSEG Board of Directors and prepare the necessary supporting financial statements. Finally, if the Board failed to act on the petition before January 28, 2003, the potentially negative impact on the utility's ability to attract reasonably priced capital that might result from the resultant OCI write-off will, the letter avers, have already begun to be felt, and may be difficult to overcome with subsequent approval of the proposed accounting.

DISCUSSION AND FINDINGS

On November 13, 2002, PSE&G filed a petition requesting that the Board issue an accounting order that would permit the Company to record a regulatory asset associated with the electric and gas portion of a Minimum Pension Liability it and its unregulated affiliates were expected to incur by the end of the year. The Board was requested to act on the petition at its public meeting scheduled for December 18, 2002, but that date was subsequently extended to January 8, 2003, the date of the Board's first regularly-scheduled public meeting in 2003.

Several meetings between PSE&G, Board Staff and the Ratepayer Advocate were held to review the petition, over 100 data requests were responded to by the Company, and initial and reply comments were filed by the Company and the RPA. The parties to the proceeding have worked diligently to conduct a thorough review of a very complex issue in a very tight time frame necessitated by the timing of the Company's request.

Due to the declining stock market, as of December 31, 2002, the market value of PSEG's (the parent company's) pension plan assets was projected to be approximately $285 million less than the plan's Accumulated Benefit Obligation, based on the market value of the plan assets as of November 30, 2002, the most recent date for which data was available prior to the Board rendering its decision on January 8, 2003. Statement of Financial Accounting Standards No. 87 requires this shortfall (the MPL) to be recorded as a liability on the balance sheet, and for stockholders' equity (accumulated Other Comprehensive Income) to be reduced by a related amount, net of tax.

Absent Board approval of the requested accounting, PSE&G asserts that the consolidated stockholders' equity of the parent company would be reduced by approximately $301 million, of which $131 million is attributable to the parent company's unregulated operations (including the utility's transmission operations) that must be booked regardless of the outcome of the petition, and $170 million is attributable to the regulated utility's gas and electric operations. If the requested accounting is approved, the utility's common equity would not be reduced by this amount, but the associated pre-tax amount ($287 million) would be recorded on the utility's balance sheet as a regulatory asset.

As asserted in the petition and in the Company's discovery responses, the requested accounting treatment would have no effect on the Company's current or future pension expense, including that claimed in the pending electric distribution rate case, since the accounting involves only balance sheet accounts and the normal ongoing pension expense that will be booked in accordance with FAS 87, whether the requested accounting is approved or denied. If, however, the accounting treatment were not approved and the resultant reduction in the utility's common equity reflected in the capital structure claimed in the rate case with no change in the rate of return on common equity sought by PSE&G (11.60%), all other things being equal PSE&G's annual revenue requirement for return (including income taxes on the equity component) would be reduced by about $6.5 million, and its charges to customers by $6.9 million after applying the 6% New Jersey Sales and Use Tax.

PSE&G argues that this reduction would be offset by an increase in its required rate of return on common equity of 35 basis points (0.35 percentage points), or from 11.60% to 11.95%, to reflect the increased risk associated with the lower equity ratio. If this adjustment were also made in the rate case, PSE&G's revenue requirement for return would actually be increased by about $0.6 million (within rounding, the increase with the SUT applied would be the same amount). The RPA contests PSE&G's use of the 35 basis points adder, which is based on the testimony of the RPA's witness in the Company's last gas base rate case, maintaining that the Company has misapplied that testimony, and that the correct adder is 10 basis points. If this adder were applied to the 11.60% ROE claimed by PSE&G, the revenue requirement for return would be reduced by $4.4 million before application of the SUT, and by $4.7 million with the SUT included, as compared to $6.5 million and $6.9 million with no risk adder.

In each case, the calculations assume a projected MPL of $285 million, based on the market value of plan assets as of November 30, 2002, and a related regulatory asset of $287 million, which would produce an OCI write-off (a reduction in the utility's common equity) of $170 million if the requested regulatory asset treatment were not approved. The calculations also reflect the updated capital structure and rate base claimed by the Company in the pending electric rate case.[27]

PSE&G cites its already-low common equity ratio of 41.5%, assertedly the least expensive from a customer standpoint of any of the state's other gas and electric utilities as a reason for granting the requested regulatory asset treatment. The Company additionally maintains that its lower equity ratio is a distinguishing factor that would allow the Board to grant PSE&G the requested accounting treatment without

[27] The "9+3" update submitted in Docket No. ER02050303, Schedules ANS-19 and ANS-20 attached to Company witness Stellwag's updated direct testimony. The rate impact estimates do not include the effect of the transmission-related OCI reduction, which must be taken regardless of whether the requested accounting is approved or not. The transmission-related OCI reduction would reduce the Company's revenue requirement for return and related income taxes by about $0.3 million.

establishing a precedent for the state's other utilities rate-regulated by the Board. The Company also cites the negative impact a reduction in the utility's equity ratio might have on its bond rating, cost of debt and equity, and access to the capital markets as a further reason for approving the requested accounting treatment.

Under Statement of Financial Accounting Standards No. 71, the requested accounting treatment would be permitted if the:

> [r]ate actions of a regulator [the Board]…provide reasonable assurance of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:
>
> (a) It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
>
> (b) Based on available evidence, the future revenue will be provided to permit recovery of the previously-incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

As indicated previously, "probable" recovery in this context means recovery that "can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved."[28]

During the course of discussion, concerns were raised as to the apparent non-applicability of this language to the proposed regulatory asset at issue here, in that the Company's petition and initial discovery responses repeatedly stressed that if approved by the Board, the regulatory asset would be extinguished through *balance sheet accounting,* or in economic terms, by changes in *asset values* occurring as a result of future plan funding, the return achieved on plan assets and the assumed discount rate at which the plan's benefits could be settled, as well as changes in *liabilities* occurring as a result of changes in plan provisions, work force demographics, and, significantly, in the case of the Company's qualified plans at issue, lower future benefit payments, since these plans have been closed to new hires since 1997.

FAS 71 on the other hand envisions the recovery of deferred *costs* or *expenses* through *rates*, an *income statement* orientation, raising an "apples and oranges" issue as to whether the proposed regulatory asset even meets the definition of the type of cost to which FAS 71 is intended to apply. Moreover, under FAS 71, it is the action of the

[28] FAS 71, paragraph 9 and footnote 6.

regulator, not exogenous economic forces, that makes the recovery probable, raising yet another basic question as to the applicability of FAS 71 to the proposed regulatory asset.

In its responses to later discovery requests,[29] the Company, while emphasizing that the MPL itself does not interact in any way with the elements of annual pension expense, indicated that changes in the level of the annual expense, as well as the funding mandated by ERISA, will ultimately be felt in asset variables that will act to extinguish the regulatory asset, even if external factors (a rebound in the stock market, for example) do not. The required action of the regulator, then, is an order stating that ongoing pension expense, prudently incurred and calculated in accordance with FAS 87, will be recoverable in rates. This clarification, together with the Company's matrices of projected measurement dates on which the extinguishment would occur, helped bridge the apparent disconnect between the FAS 71 language (and related traditional regulatory asset and amortization associated with it) and the proposed regulatory asset at issue here.

As noted previously, the D&T letter opines that PSE&G's requested accounting treatment would be an appropriate application of FAS 71, as long as the Company is able to obtain a rate or accounting order from the Board. As a practical matter, then, the question is less a matter of whether the Board *could* approve the proposed regulatory asset as it is of whether it *should*.

Impact of OCI Write-off on PSE&G's Equity Ratio and Rates

While the rate of return issues will be fully litigated at the Office of the Administrative Law and are not before the Board at this time, upon review of the Company's assertion that the rate reduction from reflecting the OCI write-off in the Company's capital structure would be offset by an increase in the required ROE, it appears to us that the Company's use of the 35 basis points risk adder for this purpose is misplaced, as argued by the Advocate. The updated ROE recommended by Company witness Morin (11.60% based on the "6+6" update filed on November 15, 2002) presumably reflects the Company's pre-write-off equity ratio of 41.5%, thus any adjustment to reflect an assumed increase in financial risk from a lower ratio (the post-OCI write-off ratio) must necessarily have that ratio as its starting point, that is, it should reflect a difference of 2 percentage points as argued by the Advocate, not the 9 percentage points asserted by the Company.

Moreover, given the current extremely low level of interest rates, the ROE ultimately allowed the Company could very well be below the 11.60% requested by the Company. If, for example, a ROE of 10% were assumed, i.e., the same ROE allowed the Company in its gas base rate case concluded in January of last year, and if the Company's

[29] In particular, the responses to RAR-2, 6,11,16,17,25 and S-PF87-50.

proposed accounting were denied and the effect of the resultant equity reduction on its capital structure reflected in the pending electric rate case, the Company's revenue requirement for return (and income taxes payable on the equity component) would be reduced by $5.0 million, and its charges to customers by $5.3 million after application of the SUT. Moreover, the notion of a risk adder would likely not apply, since the ROE allowed in the gas rate case was based on a common equity ratio even lower than that at issue here: 38.4% as compared to 39.5% in the electric case even after the OCI write-off.

The lower equity ratio employed in the gas case, moreover, was judged to be sufficient to maintain the Company's bond rating, as asserted by Company witness Stellwag,[30] who supported the appropriateness of the Company's capitalization in that proceeding. Nor did the Company argue then that a ratio that low might imperil the utility's bond rating or limit its access to capital, as it does here. The testimony of the same witness in the pending electric case indicates that the Company, in fact, has established a target equity ratio of 39% going forward (in the years 2002 through 2006), which again is asserted to be sufficient to maintain the Company's current bond rating.[31]

While the Company correctly points out that customers benefit from its lower equity ratio as compared to those of the state's other energy utilities,[32] this implicitly assumes that the equity ratios of those utilities will be approved by the Board for ratemaking purposes. The appropriateness of that will need to be carefully examined, in that the business and financial risk faced by distribution companies is generally considered to be less than that of fully integrated companies, and consequently relatively less equity may be needed in their capital structures. In PSE&G's case, this was explicitly contemplated in the Final Order concluding its restructuring proceedings, where, in reference to the use of the proceeds from securitization, the Final Order states that:

> The proceeds received by PSE&G from the issuance of $2.4 billion of transition bonds shall be utilized by PSE&G to reduce the capitalization of PSE&G, in a manner which does not substantially alter the overall capital structure of the utility adverse to the interests of bondholders or ratepayers. Consistent with maintaining an appropriate credit rating for the distribution utility, and in order to increase the ratepayer benefits that result from the use of the securitization proceeds, we view an increase in the debt component of PSE&G's (the utility's) capitalization

[30] Exhibit P-4, pg. 5; Docket Nos. GR01050297 and GR01050328.

[31] Response to S-PROR-1, pg. 18; Docket No. ER02050303.

[32] Ranging from 46% for South Jersey Gas Company to 71% for JCP&L, as determined by PSE&G based on data reported in the utilities' 10-Q's for the quarter ended September 30, 2002 (response to S-PF87-34). However, the return requirement in JCP&L's pending distribution rate case, Docket No. ER02080506, *I/M/O the Petition of Jersey Central Power & Light Company, 2002 Rates Filing*, is based on an equity ratio of 51.5%.

as falling within this requirement.[33]

Moreover, the impact of a revenue reduction of approximately $5.0 million on the Company's pending electric case must be viewed in the context of the Company's total requested increase in its distribution revenue of $250 million, as filed on May 24, 2002, and the $306 million increase it asserts could now be supported based on the "9+3" update filed on December 3, 2002.

One could argue that it wouldn't be fair to reduce the Company's common equity and revenue as a result of a precipitous and sustained stock market decline that was beyond its control. Yet, as both the Advocate and Staff have noted, this would clearly be fair and appropriate if the effect of making such a reduction was simply to eliminate an equally unusual equity benefit realized from that same stock market prior to the year 2000, with the net result being an equity balance "normalized" to eliminate the effects of both. Still, the decision to make or not make the equity reduction for ratemaking purposes is separable from the decision to approve or deny the Company's accounting proposal; that is, we could decide not to approve the requested regulatory asset treatment, yet elect not to make any related adjustment to the Company's capital structure for purposes of determining the Company's revenue requirement in the pending rate case when that issue is before us.

<u>Potential Impact on the Utility's Creditworthiness</u>

The Company's responses to data requests seeking backup for the potentially negative impacts denial of the Company's request could have on the utility's credit,[34] as asserted most specifically in the December 13th letter, do not indicate that the utility is in imminent danger of having its bond ratings reduced by the major rating agencies (S&P and Moody's). Moreover, the outcome of the Company's pending rate case is likely to be a far more significant determinant of the utility's credit quality in the eyes of the rating agencies than the outcome of this proceeding.

The Company's senior debt is currently rated a "low A" by S&P and Moody's (A- and A3, respectively), and single "A," a notch above that rating, by Fitch. Both Moody's and S&P have the utility's credit ratings on stable outlook, while Fitch maintains a negative outlook, noting that "favorable rate treatment will be critical to improving currently weak utility credit measures and to maintaining the existing utility ratings."[35] Were Fitch to downgrade, it would presumably be to A-, thus joining the other two rating agencies at this level.

[33] Order dated August 24, 1999 in Docket Nos. EO97070461, *et al*, pg. 107.

[34] The initial and supplementary responses to S-PF87-61.

[35] Initial response to S-PF87-61, pg. 1; supplementary response to S-PF87-61, pg. 60.

If the Company's bond ratings were to be reduced one notch, i.e., to BBB+, it estimates that its cost of long-term debt would be increased by about 60 basis points, based on the yields on its bonds compared to those of comparable debt issues of five utilities rated triple B.[36] The Company's only immediate need for outside capital is to refund $300 million of debt maturing this year. The 60 basis point differential applied to this issue would equate to increased interest of $1.8 million per year. However, a more broadly-based bond yield comparison, S&P's index of A-rated electric utility bond yields compared to its index of yields of utilities rated triple B[37] over the three-year period ended 2001, suggests the yield spread could be less than half the 60 basis points estimated by the Company, or 26 basis points. Based on this spread, the impact on the $300 million bond issue would be an increase in annual interest of about $0.8 million per year. Thus the added interest cost is estimated to range from $0.8 million to $1.8 million, as compared to the potential rate reductions ranging from $5.0 million to $6.5 million noted above.

However, the Board views even a downgrade as mild as to BBB+ to be unlikely in the event the Company's petition is denied. In reaffirming its triple B rating for the parent company on May 28, 2002, S&P noted that the regulated electric and gas distribution utility is a "key subsidiary…with a stable customer base…that is expected to produce strong and stable cash flows." On that same date, while lowering the utility's corporate credit to triple B from A -, S&P reaffirmed the A- rating on the Company's senior secured debt with a stable outlook, and went on to note that the utility's "debt burden is manageable because funds from operations have and are projected to continue to produce sound coverage of interest expense." In summarizing its outlook for the Company, S&P once again noted the importance of the utility's stable customer base, as well as the outcome of the pending rate case, stating that "[e]xpectations of stable cash flows at the utility are attributable to favorable customer base demographics and the utility's exit from the gas and electric commodity businesses. The level of rate relief granted in the utility's upcoming electric rate proceeding will be important to stable credit quality for PSE&G, its parent, and its affiliated companies."[38]

Similarly, in reaffirming its A3 rating on the utility's senior debt with a stable outlook on October 11, 2002, Moody's cited the importance of the rate case, and the likelihood that its outcome would be reasonable: "In May 2002, PSE&G…filed an application with the NJBPU for a $250 million, or 12.8% increase in electricity distribution revenues. The NJBPU is expected to issue a rate order by mid-2003 for the new rates to go into effect

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[36] Carolina Power & Light, Cincinnati Gas & Electric, Consolidated Natural Gas, Detroit Edison (apparently still rated A-/A3, however), and Oncor Electric; initial response to S-PF87-61, pg. 2.

[37] As reported in S&P's November 2002 Bond Guide on page 3.

[38] Response to S-PF87-61 (suppl.), pgs. 2,3,6 and 7.

on August 1, 2003, the end of the competitive transition period. We believe that the New Jersey regulators would likely issue a reasonable rate decision next year."[39]

As a more immediate concern, the Company states that any negative outlook placed on it by the rating agencies might temporarily disrupt its ability to place commercial paper, of which it has $100 to $200 million outstanding on any given day, and which is currently rated A2/P2, assertedly the minimum necessary to sustain its $400 million program.[40] The recently-augmented bank lines discussed below should, however, be more than sufficient to tide the Company over such a disruption in the unlikely event a downgrade occurs.

Potential Impact on the Parent Company's Creditworthiness

As a result of $535 million in write-offs associated with the parent company's investments in Argentina, Brazil, India and PSEG Energy Technologies taken in the second and third quarters of 2002, the parent company's equity ratio stood at 26.7% as of September 30, 2002.[41] Moreover, prior to the issuance in that same month of a $460 million preferred issue convertible into common stock, the parent company's debt ratio, including short-term debt but exclusive of securitization and non-recourse debt, was 66.7%. After the preferred issue, the debt ratio was reduced to 64.4%. Both ratios were improved in November by a $443 million common stock issue, bringing the common equity ratio up to 29.5% and the debt ratio down to 61.8% on a pro-forma basis reflecting the stock issue.[42] An additional $180 million of preferred securities issued on December 11, 2002 brought the debt ratio down to 61.0% and the equity ratio up to 30.4% on the same pro-forma basis. Thus, since September of last year, over $1 billion of additional equity has been injected into the parent company, and its debt ratio has been reduced to a level well below the 70% limit established in its lending agreements.

Moreover, on December 19, 2002, PSEG entered into a new three-year, $350 million revolving credit agreement, thereby increasing its total lines of credit to $2.47 billion, of which approximately $2.0 billion is currently available to support the operations of the PSEG subsidiaries, including the utility.

These steps have not gone unnoticed by the investment community. In upgrading Enterprise's common stock to 1-overweight on December 12, 2002, Lehman Brothers noted that "PEG's [PSEG's] financial profile looks much improved on the heels of

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[39] *Ibid.*, pgs. 14 and 17.

[40] Response to S-PF87-61, pgs. 2-3.

[41] As indicated in the Company's response to S-PF87-31 (suppl.).

[42] The November actuals were not available at the time S-PF87-31 (suppl.) was responded to.

$1.04B of equity/preferred issued in 2H'02 and the near-term upsizing of a Parent revolver. PEG should end the year with $1.5B excess liquidity and 61.8% debt/cap, down from 68.5% at mid-year. Risks remain from Lat Am assets and generation lease portfolio, but potential write-offs unlikely to change outlook. With that in mind, the swing factors in PEG's story are around New Jersey regulatory outcomes: the BGS auction and electric rate case. Historically, these processes have produced reasonable outcomes."[43] Moreover, in projecting the parent company's debt ratio as of December 31, 2002, Lehman Brothers assumed an MPL-related OCI write-off of $200 million.

Similarly, Merrill Lynch, which maintains a buy rating on the stock, in a December 20, 2002 research note commenting on the new three-year $350 million revolving credit agreement signed the previous day, found that securing a "multi-year deal in the current environment is a positive in itself, and the upsized facility is a further vote of confidence in PEG's credit position. We note that the upsized bank deal is the latest in a series of positive developments on the credit and liquidity front which demonstrates clearly that the company continues to have good access to the markets. PEG also recently completed the placement of $180M trust preferred securities and a common equity issuance last month raised $398M of gross proceeds. Other financings completed in H2 2002 include a private debt placement for $245M in October and $460M of equity units in September. With the new $350M bank facility in place, PEG and its subsidiaries now have aggregate liquidity of $2.47B with $2.0B currently available. This would seem to be very adequate given only $600M of maturities in 2003 ($300M of which are at the utility) and quite modest rating triggers." With respect to the pending electric rate case, Merrill went on to note that "[o]nce the BGS auction is done, attention will likely shift to the PSE&G electric rate case. With a reasonable intervener recommendation in hand, we are optimistic of a constructive outcome."[44] These same factors in turn may have led Credit Lyonnais Securities to upgrade its recommendation on PSEG's common stock from "add" to "buy" on January 7, 2003.

Given the above, the worst of the financial uncertainties evident in the first half of last year appear to be largely behind the parent company, and the steps it has taken to bolster its balance sheet suggest that it is strongly positioned from a financial standpoint going forward. Moreover, because many utilities and non-utilities alike will be booking MPLs in 2002, and that expectation has been out there for some time, a non-cash OCI write-off in all probability will not be perceived as being unique to the Company, as indicated by its treatment in the Lehman Brothers research note, i.e., as a balance sheet footnote, not a major event.

Thus, the significant steps taken to shore up the parent company's balance sheet in the last quarter of 2002 have been received very positively by the investment community, and have led to at least two recent analysts' recommendations to buy the parent

[43] Supplementary response to S-PF87-61, pgs. 21 and 22.

[44] *Ibid*., pg. 28.

company's common stock.[45] With the parent company's debt ratio now well below the 70% limit contained in its lending agreements, an OCI write-off, a significant portion of which must be taken regardless of the outcome of this proceeding, presents little danger of exceeding this limit. Moreover, the OCI reduction is not permanent, but will be restored going forward via credits to OCI on the measurement date as the stock market hopefully improves. Even absent a rebounding stock market, the equity reduction will ultimately be restored via the normal pension accounting prescribed by FAS 87.

With respect to the Company's relatively low equity ratio (41.5% pre-OCI write-off and 39.5% post-OCI write-off), while it is true that it is below the ratios of the other gas and electric utilities regulated by the Board (more specifically the equity ratios of the electric utilities that have, or will have, pending base rate cases before the Board[46]), this could be viewed as indicating that those ratios may be too high, rather than the Company's ratio is too low, for the reasons noted previously. Moreover, an even lower ratio, 38.4%, was employed in the Company's gas base rate case concluded in January of last year, and the Company did not argue then that a ratio that low might imperil the utility's bond rating or limit its access to capital, as it does here. Finally, in the electric rate case, the Company is targeting an equity ratio of 39% going forward, which it asserts is consistent with maintaining its current A3 bond rating.

Having said that, denial of the proposed accounting would not necessarily imply that the resultant OCI reduction must be made for ratemaking purposes. In view of the Company's relatively low equity ratio and its associated benefit to ratepayers, and the argument that the Company should not have its revenue requirement reduced as a result of a declining stock market over which it has no control, the Board will decide whether to make the equity reduction for purposes of determining the Company's revenue requirement when that issue is before it, independently of its decision on the Company's accounting proposal. An equity reduction could be viewed as simply offsetting a prior benefit (increase in equity) arising from the same source (the pre-2000 stock market), and therefore should be made. The Board believes that, given the abbreviated time frame of this proceeding and the complexities of pension accounting, this issue is worthy of further consideration in the Company's pending electric base rate case. The Board's decision accordingly preserves for ratepayers the possibility of such a rate reduction, while at the same time allowing the parties the opportunity to set forth their arguments as to why such a reduction should or should not be made, including any asserted offsetting effect of the lower equity ratio on PSE&G's required equity return.

The modifications to the Company's proposed accounting treatment suggested by Staff (and apparently found acceptable by the Company, as indicated in the December 13th

[45] Lehman Brothers and Credit Lyonnaise, as just noted.

[46] In addition to PSE&G, JCP&L and RECO have pending base rate cases before the Board, and Atlantic City Electric Company is to file its base rate case in the first half of this year.

letter) would address several of the concerns expressed by Staff and the RPA. They are as follows:

1. Eliminating the possibility of typical FAS 71 amortization (direct amortization of a fixed amount over a fixed time period through the income statement) by stating that the recovery of the regulatory asset can only occur through the operation of the accounting prescribed by FAS 87, and in particular, the balance sheet accounting that occurs on the measurement date.

2. Eliminating the "open endedness" of the proposed accounting by stating that it will expire upon the extinguishment of the regulatory asset.

3. Limiting the amount to be recovered to the regulatory asset booked on the December 31, 2002 measurement date, currently estimated to be $287 million, based on a projected MPL of $285 million.

4. Continuing to review the issues raised by Staff and the RPA, including the prudency and appropriate level of the regulatory asset and its effect on rates, in the Company's pending electric distribution base rate case.

While bounding the proposed accounting treatment in this manner would make PSE&G's proposal more acceptable from a ratepayer standpoint, as well as more tightly tie it to the facts and circumstances unique to the Company, a Board finding that PSE&G's proposed regulatory asset would qualify for that treatment under FAS 71, is, in the Board's view still problematic, and could still be viewed as establishing a new regulatory policy that, in fairness, arguably would have to be extended to the state's other utilities, none of which, however, has sought such treatment to date. As noted above, New Jersey Resources, Inc., the parent company of New Jersey Natural Gas Company, and FirstEnergy Corp., the parent company of JCP&L have already booked their MPLs to OCI. Also as noted above, while the Board believes it has the authority to approve the proposed regulatory asset treatment, the question is whether it *should*, thereby potentially creating a new class of very substantial deferrals (about $300 million for PSE&G alone) while the Board at the same time copes with approximately $1 billion of deferrals the electric utilities are projected to incur as they complete the restructuring mandated by the Electric Discount and Energy Competition Act. The Board does not think such a course of action would be prudent or necessary at this time.

For all of the above reasons, the Company's request to establish a regulatory asset associated with the gas and electric portion of the Minimum Pension Liability it will book in its fiscal year ended December 31, 2002 is HEREBY DENIED. Accordingly, the Company is HEREBY DIRECTED to charge the utility's Other Comprehensive Income for the net of tax amount associated with the regulatory asset that otherwise would have been booked, and, as part of the Company's "12+0" update in its pending electric distribution rate case, to reflect, as a known and measurable change, the effect of this charge on the utility's capital structure. The Company's allowed rate of return will be determined as part of the rate case.

DATED: 1/23/03

BOARD OF PUBLIC UTILITIES
BY:

(SIGNED)

JEANNE M. FOX
PRESIDENT

(SIGNED)

FREDERICK F. BUTLER
COMMISSIONER

(SIGNED)

CAROL J. MURPHY
COMMISSIONER

(SIGNED)

CONNIE O. HUGHES
COMMISSIONER

(SIGNED)

JACK ALTER
COMMISSIONER

ATTEST:

(SIGNED)
KRISTI IZZO
SECRETARY